

# SIX CRITICAL ELEMENTS OF FINANCIAL REFORM

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Financial reform is moving fast and it is likely to pass the Senate within days. Much of the action will take place on the floor, where amendments will be debated and voted on. What should progressives fight for at this point, and what amendments accomplish these goals?

This bill is the first step on a long journey towards a financial system less prone to collapse that will return to working for the real economy. With that in mind, small changes made in the Senate bill could have a large effect in building a much more stable financial system. Here are six essential goals for financial reform, plus a look at where each stands in the House and the Senate.

## 1. TOO BIG TO FAIL IS TOO BIG TO EXIST.

Resolution authority is an untested strategy for breaking up large firms with trillions of dollars of assets that exist in many major markets. The collapse of the largest firms will add significant systemic risk regardless of how well prudential regulation is carried out. The large concentration among the top players is a danger to the financial markets, and in order to make this bill credible, there needs to be a size cap on the largest firms.

There is currently no language to this effect in the House or Senate Bill. Senators Brown, Kaufman, Casey and Whitehouse have introduced their Safe Banking Act of 2010, which would reduce the amount of non-deposit liabilities to 3 percent of US GDP for non-banks (and 2 percent for banks).

**2. HARD LEVERAGE CAP:** A major reason why our recession is so deep, with unemployment so high, is that the SEC allowed the largest players to significantly increase their leverage during the bubble. Though a leverage cap won't replace a full regimen of proper capital reserving – which the administration is leaving to the international community to figure out – as citizens, we should demand a hard cap on how risky the financial sector can get. This would supplement good prudential regulation, not replace it.

There is currently a 15:1 leverage cap in the House Bill, though there currently isn't one in the Senate. Senators Brown, Kaufman, Casey and Whitehouse have introduced their Safe Banking Act of 2010, which would require that banks to set into law a 16.67:1 leverage limit.

	WHAT IT DOES	STATUS IN HOUSE	STATUS IN SENATE
<b>TOO BIG TO FAIL</b>	Liabilities not to exceed 3% of US GDP.	No language to this effect.	In the proposed Safe Banking Act of 2010 amendment (Brown, Kauffman, Casey, and Whitehouse). Status uncertain.
<b>HARD LEVERAGE CAP</b>	Create a hard limit to the risk of banks, supplements international capital models.	15:1 in the law.	16.67:1 proposed in the Safe Banking Act of 2010 (Brown, Kauffman, Casey and Whitehouse). Status uncertain.
<b>BANKS PAY FOR THEIR OWN CLEANUP</b>	Banks have to prepay for costs related to resolution.	Prefunding up to \$150 billion dollars	Prefunding up to \$50 Billion Dollars
<b>DERIVATIVES</b>	Bring the dangerous over-the-counter derivatives market into the sunlight through clearinghouses, then exchanges, with capital requirements for what doesn't clear, and a narrow end-user exemption.	House bill is widely considered to be weak.	Senator Lincoln's language, voted out of committee, provides strong derivatives reform, and efforts to weaken it should be fought.
<b>OFF-BALANCE SHEET</b>	A reworking of the way off-balance sheets are disclosed to investors, along with private rights of action, are essential to market integrity.	House bill has weak to non-existent language on this matter.	Senator Menendez has announced an amendment to address the major issues related to off-balance sheets. Status uncertain.
<b>VOLCKER RULE</b>	Sets a limit on liabilities as well as protects the federal discount window from being used for risky gambling.	House bill doesn't have it present.	Senators Merkley and Levin have proposed an amendment that handles the Volcker Rule, while also taking on conflicts of interest. Status uncertain.

### 3. RISKY BANKS PAY FOR THEIR OWN CLEANUP

The bill must retain a resolution fund to unwind a failed financial firm when the time comes. This must be pre-funded by industry for several reasons: it discourages banks from becoming too big unless there is a good reason; it is countercyclical, which is good for stopping the buildup of risks; and because when a crisis hits, the remaining firms will be too weak to pay. Paying in the good times to hedge the bad times is common sense.

Right now, the House bill allows for pre-funding up to \$150 billion dollars, and the Senate for up to \$50 billion dollars. The White House has considered removing the pre-funding language based on “optics”—but this mechanism must be defended.

### 4. DERIVATIVES

Any time you look at something that failed in the crisis, the over-the-counter derivatives market is there making it worse. Without significant derivatives reform, the bubbles and the gambling will continue to get amplified. And without significant derivatives reform, resolution authority is simply not possible.

There is derivatives language in the House bill that is widely considered weak. Barney Frank has said he would like to strengthen it before the bill is signed into law, so it is very important that strong derivatives language comes from the Senate. Strong derivatives language crafted by Senator Lincoln has passed through the Agriculture Committee. Fighting to keep loopholes out of it is essential for financial reform.

### 5. OFF-BALANCE SHEETS

There needs to be a change in the way off-balance sheet products are disclosed. In particular, liabilities should include, but not be limited to, liabilities associated with swaps and VIEs. And there should be a private right of action for failure to comply.

There is not extensive language on off-balance sheet reform in the House. Senator Menendez has announced an amendment to address these issues, and it is essential to the integrity of our markets that it is incorporated into the Senate bill.

### 6. VOLCKER RULE

The Federal Reserve discount window is a form of financial insurance that is used to protect our checking accounts and to make sure the payment system doesn't collapse in the middle of a liquidity crisis. It should not be a plaything for swaps desks and financial traders who can use this social insurance to make bigger bets and use the advantage to crowd out the rest of the market. The Volcker Rule is essential for restoring the stability and integrity of what our financial system does.

The Volcker Rule was announced after the financial reform bill left the House, so it is not present in the passed House bill. Senators Merkley and Levin have proposed an amendment that not only solidifies the Volcker Rule, but also specifically targets the conflict of interest that we have seen with Goldman-style bets against clients.

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